STAFF PAPER

July 2016

IFRS® Interpretation Committee Meeting

Project	**Foreign Currency Transactions and Advance Consideration**
Paper topic	Analysis of matters raised in comment letters

CONTACT(S)	Michelle Sansom	msansom@ifrs.org	+44 (0)20 7246 6410
	Arjuna Dangalla	adangalla@ifrs.org	+44 (0)20 7246 6473
	Sung-ho Joo	sjoo@ifrs.org	+44 (0)20 7246 6947

Introduction

1. In October 2015, the IFRS Interpretations Committee (the Interpretations Committee) published a draft IFRIC Interpretation *Foreign Currency Transactions and Advance Consideration* (the draft Interpretation). The comment period ended on 19 January 2016.

2. In May 2016, the Interpretations Committee discussed the feedback received and commenced its deliberations of the significant matters raised in comment letters on the draft Interpretation.

Purpose and structure of this paper

3. This paper continues the discussion from the May 2016 Interpretations Committee meeting of significant matters raised in comment letters. At that meeting, we agreed to bring the following matters for further discussion:

    (a) transactions with a significant financing component (paragraphs 5–11);

    (b) embedded derivatives (paragraphs 12–16);

    (c) costs of implementation (paragraphs 17–29); and

    (d) effective date (paragraph 30–35) .

4. In addition to the topics listed above, we have considered further the transition requirements for first-time adopter (paragraphs 36–49).

Transactions with a significant financing component

Feedback received

5. As discussed at the May 2016 Interpretations Committee meeting, some respondents to the draft Interpretation stated that it should specifically address transactions with a significant financing component, as described in IFRS 15 *Revenue from Contracts with Customers*.[1]

Background

6. The Interpretations Committee decided in March 2015 that the draft Interpretation and accompanying examples should not explicitly address transactions with a significant financing component. The Interpretations Committee decided that the expected consequences of applying IAS 21 *The Effects of Changes in Foreign Exchange Rates* and its draft Interpretation to transactions with a significant financing component would be clear.

7. At the March 2015 meeting, the Interpretations Committee discussed the following example:

> Suppose an entity entered into a contract with a customer to sell goods for FC100 at the date of delivery in 14 months' time or FC90 receivable now. The entity receives FC90 from the customer at contract inception and recognises a contract liability for FC90 translated using the exchange rate at that date. The entity determined that the difference of FC10 (between FC90 now and FC100 in 14 months' time) was a significant financing component. It therefore recognised the FC10 as (a) interest expense in profit or loss and (b) a corresponding increase in the contract liability over the 14

[1] IFRS 15, paragraphs 60–65.

months from the date of receipt of the consideration to the date of delivery of the goods. The entity would translate the FC10 using the exchange rates over the period from contract inception to the delivery of the goods. (Applying paragraph 22 of IAS 21, an entity may use average exchange rates if exchange rates do not fluctuate significantly.) Hence, applying the approach in the proposed Interpretation, on transfer of the goods, the entity recognises revenue of FC100, of which:

(a) FC90 is translated using the exchange rate at the date of recognition of the initial FC90 contract liability; and

(b) FC10 is translated using the exchange rates over the period of financing (ie from contract inception to the delivery of the goods).

8. At the Interpretations Committee in May 2016, given the number of respondents who suggested that the Interpretation address transactions with a significant financing component in an Illustrative Example, the Interpretations Committee supported a staff recommendation to draft an Illustrative Example addressing the issue.

Staff analysis and recommendation

9. Applying paragraph 22 in IAS 21, 'the date of the transaction' for the accretion of interest is the date(s) that the interest first qualifies for recognition.

10. In developing an Illustrative Example for transactions with a significant financing component, the Interpretation Committee asked the staff to refer to an existing example in the draft Interpretation or other IFRS Standards to avoid unintentionally interpreting other aspects of the transaction.

11. After considering the Illustrative Examples in the draft Interpretation, the staff think that extending any of the current examples to include a significant financing component will add complexity, and may result in a loss of clarity about the point being illustrated by the particular example. Consequently, the staff recommend that the Illustrative Example in paragraph 7 of this paper be included in the Interpretation, on the basis that it was discussed at a previous meeting and illustrates the point clearly.

Embedded derivatives

Feedback received

12. In response to the draft Interpretation, PwC noted that it does not address embedded foreign currency derivatives that require separation at contract inception. PwC proposed that the Interpretation should:

    (a) clarify that an entity first needs to evaluate transactions within its scope for embedded derivatives applying IAS 39 *Financial Instruments: Recognition and Measurement* or IFRS 9 *Financial Instruments*; and

    (b) address how the requirements in the Interpretation applies in these circumstances.

Staff analysis and recommendation

13. IAS 21, paragraph 24 states:

    > The carrying amount of an item is determined in conjunction with other relevant Standards. For example, property, plant and equipment may be measured in terms of fair value or historical cost in accordance with *IAS 16 Property, Plant and Equipment.* Whether the carrying amount is determined on the basis of historical cost or on the basis of fair value, if the amount is determined in a foreign currency it is then translated into the functional currency in accordance with this Standard.

14. The staff think that paragraph 24 of IAS 21 clearly requires an entity to first evaluate transactions for embedded derivatives that require separation at contract inception applying IAS 39 or IFRS 9. Accordingly, we suggest the Interpretation need not clarify that an entity first evaluates such transactions for embedded derivatives.

15. In considering PwC's proposal to address how the requirements in the Interpretation apply, we note that the Interpretation applies only to foreign currency transactions for which an entity recognises a non-monetary asset or non-monetary liability relating to advance consideration before it recognises the related asset, expense or income. Only in limited circumstances would an entity have a transaction for which:

(a) it paid or received advance consideration in a foreign currency;

(b) it recognises a separate embedded derivative; and

(c) the host contract is not in the entity's functional currency.

16. We suggest that it is unnecessary to specifically address the accounting for the host contract that is not in the entity's functional currency on the grounds that:

(a) the requirements in the Interpretation apply equally to accounting for a host contract denominated in a foreign currency when consideration has been paid or received in advance as they do to other such foreign currency transactions. We do not expect application of the Interpretation to such host contracts to be particularly difficult to understand or apply; and

(b) as noted above, we think there are limited circumstances in which the Interpretation will be applicable to transactions that contain an embedded derivative.

Costs of implementation

Feedback received

17. Two respondents had reservations about the costs of implementing the proposals in the draft Interpretation.[2] These respondents stated that most Enterprise Resource Planning systems (ERPs) are designed for the 'multi-transaction' approach. Moving from a multi-transaction approach to a one-transaction approach, as proposed in the draft Interpretation, will require entities to modify systems, and thus costs will be incurred.

Staff Analysis

18. The Interpretations Committee has acknowledged throughout this project that two practices are commonly applied—the one-transaction and the multi-transaction

[2] Mazars (CL35), Swiss Holdings (CL37).

approach. Unless the Interpretations Committee permits both practices to continue, implementation costs for one group of preparers is inevitable.

19. The staff note that the feedback received on the draft Interpretation did not suggest that implementation of the proposals is impractical.

20. We have evaluated the likely effects of the Interpretation, using the Board's cost-benefit assessment criteria, as per paragraph 3.75 of the *Due Process Handbook*. This includes how likely the Interpretation would be to:

(a) improve comparability of financial information between different reporting periods for the same entity and between different entities in a particular reporting period (see paragraphs 21–23);

(b) improve the ability of users of financial statements to assess the future cash flows of an entity, and also improve economic decision-making as a result of improved financial reporting (see paragraphs 24–25);

(c) affect the costs of analysis for users of financial statements (see paragraph 26); and

(d) affect the compliance costs for preparers (see paragraphs 27–29).

Comparability of financial information

21. In considering the submission to the Interpretations Committee, the staff undertook outreach with regulators, standard-setters and the technical teams of the large accounting firms. The outreach identified diversity exists in practice when a reporting entity selects the exchange rate to use for the recognition of revenue for transactions in which there is advance consideration. The outreach also indicated that this is a common issue across a number of jurisdictions and particularly within the construction industry.

22. The Interpretation, which requires a one-transaction approach, will reduce diversity in practice, not only for revenue recognition transactions but also other foreign currency transactions for which consideration is paid or received in advance (for example, the sale or purchase of assets, goods or services). This will reduce the appearance of

economic dissimilarity for identical transactions between entities using the one-transaction approach and those using the multi-transaction approach.

23. Specifying the one-transaction approach improves the comparability of information about transactions denominated in foreign currency.[3]

Consistency in application

24. The Interpretation will enhance consistency in determining ' … the date on which the transaction first qualifies for recognition in accordance with IFRSs.', as stipulated in paragraph 22 of IAS 21, eg when consideration is paid or received in advance. The Interpretation states that the 'date of the transaction' is the date of initial recognition of the non-monetary asset or non-monetary liability relating to advance consideration.

25. In interpreting 'the date of the transaction', the Interpretation will permit only the one-transaction approach, contributing to consistency in application. Consistency will enhance users' economic decision-making.

Costs of analysis for Investors

26. We did not receive any feedback to suggest that the Interpretation would affect the costs of analysis for investors. Although we did not receive any specific feedback from investors, we think that the one-transaction approach will benefit investors in assessing an entity's overall exposure to foreign currency risk. This is because the Interpretation will provide consistency in the reported amount of exchange gains or losses in the income statement.

Compliance costs for preparers

27. The significance of the implementation costs to preparers will depend on (a) the frequency and complexity of foreign-currency denominated transactions that include advance consideration and (b) each preparer's existing ERP systems. Preparers that previously applied the multi-transactional approach will incur a one-time cost to modify their systems.

[3] Please refer to paragraph 21 of Agenda paper 14 presented at the November 2014 Interpretations Committee meeting.

28. The Interpretation does not require any financial statement disclosures and the staff do not anticipate additional costs relating to internal controls or audit processes.

29. Consequently, other than possible ERP system modifications, the staff do not foresee any significant ongoing costs in applying the Interpretation.

Effective date

Feedback received

30. Although the Interpretations Committee did not ask for comments on the effective date of the Interpretation, five respondents provided comments. Some of those respondents proposed that the effective date should be aligned with the effective date of IFRS 15. This is because many of the transactions in the scope of the Interpretation are also within the scope of IFRS 15. In their view, these respondents consider that aligning the effective date of the Interpretation with IFRS 15 will minimise implementation costs.

31. In contrast, the Australian Accounting Standards Board (CL12) did not consider it necessary to align the effective date of the Interpretation to that of IFRS 15 because the Interpretation interprets IAS 21.

32. Other respondents proposed that the effective date of the final Interpretation should be at least 12 months after it is issued to allow time to implement the changes.[4]

Was the matter discussed in developing the draft Interpretation?

33. At its meeting in January 2015, the Interpretations Committee tentatively decided that the effective date should not be earlier than the effective date of IFRS 15 (ie for accounting periods beginning on or after 1 January 2017[5]), but earlier application should be permitted. The staff made this recommendation on the basis of feedback, which indicated that consideration is often paid in advance on long-term construction

[4] SwissHoldings (CL37), Nestle (CL43).

[5] The effective date of IFRS 15 has been amended to annual reporting periods beginning on or after 1 January 2018.

contracts. The staff thought it would be preferable for entities affected by both the Interpretation and IFRS 15 to be permitted to apply the new requirements in both documents at the same time.

Staff analysis and recommendation

34. The staff support the view of those respondents that said the effective date of the Interpretation should be aligned with that of IFRS 15. This view is consistent with the Interpretations Committee's previous view that the effective date should not be earlier than the effective date of IFRS 15. This effective date (ie 1 January 2018) provides entities with sufficient time to apply the Interpretation, in the light of our expectation that we will issue it in 2016 (subject to approval by the Interpretations Committee).

35. Consequently, the staff recommend an effective date of 1 January 2018, with earlier application permitted.

Questions 1 and 2—Remaining issues arising from comment letters

1. Does the Interpretations Committee agree with the staff recommendation:

(a) not to address embedded derivatives in the Interpretation; and

(b) that the effective date of the Interpretation should be 1 January 2018, with earlier application permitted?

2. Does the Interpretations Committee have any further comments on:

(a) the proposed Illustrative Example for transactions with a significant financing component; and

(b) the costs of implementing the Interpretation?

Transition relief for first-time adopters

May 2016 Tentative decision

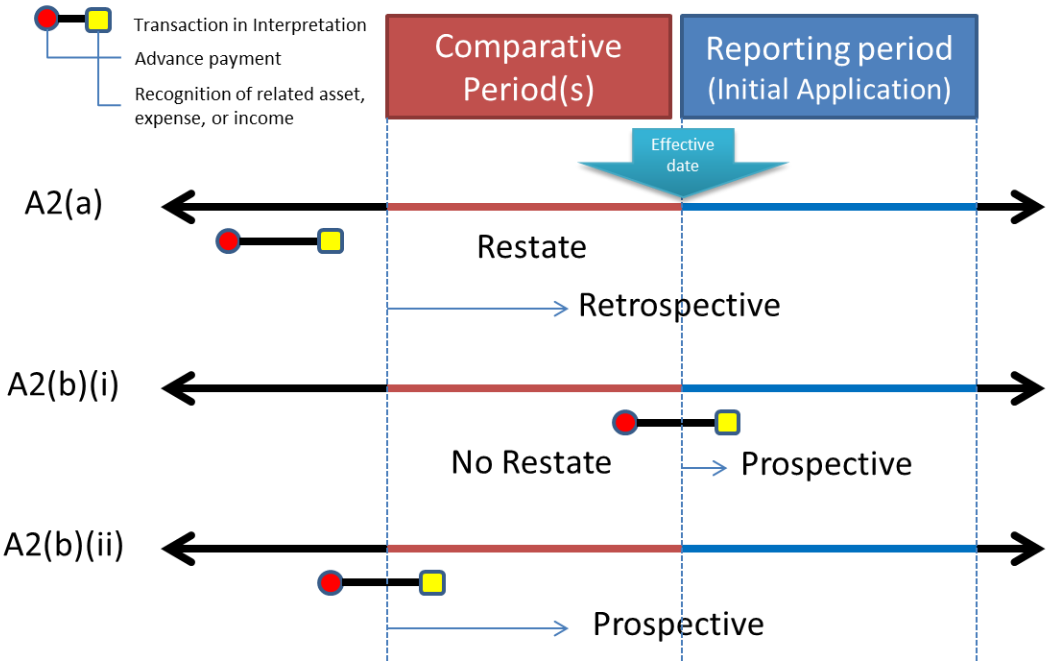
36. At its meeting in May 2016, the Interpretations Committee tentatively decided to:

(a) retain the transition requirements in the draft Interpretation; and

(b) provide first-time adopters of IFRS Standards with the same transition relief as is provided to entities already applying the Standards.

37. The staff have considered further the Interpretations Committee's tentative decision to provide first-time adopters of the Standards with transition relief.

38. The draft Interpretation provides the following transitional provisions:



39. Paragraph A2(b)(i) of the draft Interpretation permits an entity to apply the Interpretation prospectively from the beginning of the reporting period in which the entity first applies it ('the date of initial application'). Accordingly, an entity would:

(a) not restate amounts previously reported;

(b) apply the requirements of the Interpretation to any asset, expense or income recognised after the date of initial application for which a non-monetary asset or non-monetary liability relating to advance consideration was recognised before that date; and consequently

(c) translate that asset, expense or income using the spot exchange rate at the date of the initial recognition of the non-monetary asset or non-monetary liability.

Possible conflict with the principle for first-time adopters

40. On further consideration, the staff note that if a first-time adopter is provided with the same transition relief as an entity already applying IFRS Standards, it can choose paragraph A2(b)(i) of the draft Interpretation. Paragraph A2(b)(i) does not require an entity to present full comparative information.

41. Paragraph 6 of IFRS 1 *First-time Adoption of International Financial Reporting Standards* states:

> 6 An entity shall prepare and present an opening IFRS statement of financial position at the date of transition to IFRSs. This is the starting point for its accounting in accordance with IFRSs.

42. IFRS 1 defines the date of transition to IFRSs as:

> the beginning of the earliest period for which an entity presents full comparative information under IFRSs in its first IFRS financial statements.

43. If first-time adopters are provided with the transition provisions in A2(b)(i), the staff think that the first-time adopter cannot also comply with the requirements of IFRS 1. Consequently, the staff recommend that first-time adopters are not permitted to apply the transition relief in A2(b)(i).

44. The staff note that this recommendation is consistent with the requirements of IFRS 15 for first-time adopters. Paragraph A2(b)(i) has a similar effect on transition to the method permitted by IFRS 15: retrospective application with the cumulative effect of initially applying IFRS 15 recognised at the date of initial application—that approach results in no restatement of information reported for comparative periods. IFRS 1 does not provide transition relief for first-time adopters in relation to IFRS 15. This is because it would eliminate comparability within a first-time adopter's first IFRS financial statements by providing relief from restating comparative years[6].

[6] IFRS 15, paragraph BC508.

Other cases for reference

45. IFRS 1 does, however, provide transition relief for first-time adopters in relation to other Interpretations, for example, IFRIC 12 *Service Concession Arrangements*, and IFRIC 20 *Stripping Costs in the Production Phase of a Surface Mine* as follows:

IFRS 1, paragraph D22:

> A first-time adopter may apply the transitional provisions in IFRIC 12.

IFRIC 12, paragraph 30:

> If, for any particular service arrangement, it is impracticable for an operator to apply this Interpretation retrospectively at the start of the earliest period presented, it shall:
>
> (a) recognise financial assets and intangible assets that existed at the start of the earliest period presented;
>
> (b) use the previous carrying amounts of those financial and intangible assets (however previously classified) as their carrying amounts as at that date; and
>
> (c) test financial and intangible assets recognised at that date for impairment, unless this is not practicable, in which case the amounts shall be tested for impairment as at the start of the current period.

IFRS 1, paragraph D32,

> **Stripping costs in the production phase of a surface mine**
>
> A first-time adopter may apply the transitional provisions set out in paragraphs A1 to A4 of IFRIC 20 *Stripping Costs in the Production Phase of a Surface Mine*. In that paragraph, reference to the effective date shall be interpreted as 1 January 2013 or the beginning of the first IFRS reporting period, whichever is later.

46. The transition provisions above are consistent with the principle in IFRS 1, and require the presentation of comparative information applying the requirements in the respective Interpretations.

47. In addition to the above, the staff note the Interpretation on IAS 21 applies only to a foreign currency transaction for which an entity recognises a non-monetary asset or non-monetary liability relating to advance consideration, before the recognition of a related asset, expense or income. Accordingly, the Interpretation has a narrower scope than IAS 21.

48. Consequently, providing transition relief for transactions within the scope of the Interpretation would create different transition provisions for first-time adopters depending on the payment terms of an asset. For example, if a first-time adopter paid for property, plant or equipment in advance, there would be different transition requirements than for property, plant or equipment paid for in arrears, even though both transactions may have occurred in previous reporting periods.

Staff recommendation

49. The staff recommend that the Interpretations Committee does not provide transition relief for first-time adopters (a) because of the possible conflict with the principle in IFRS 1 and (b) because the Interpretation interprets only one aspect of IAS 21 for particular foreign currency transactions. Nonetheless, should the Interpretations Committee wish to retain its position to provide transition relief to first-time adopters, we recommend removing the transition relief in A2(b)(i), so that first-time adopters can use only the relief in A2(b)(ii). This will ensure that a first-time adopter complies with the principle in IFRS 1.

Question 3 – Reconsideration of transition for first-time adopters
3. Does the Interpretations Committee agree with the staff recommendation not to provide transition relief for first-time adopters?